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INTERGOVERNMENTAL NEGOTIATING COMMITTEE
FOR A FRAMEWORK CONVENTION ON CLIMATE CHANGE
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Item 3 (a) and (b) of the provisional agenda

MATTERS RELATING TO ARRANGEMENTS FOR THE FINANCIAL MECHANISM AND FOR TECHNICAL AND FINANCIAL SUPPORT TO DEVELOPING COUNTRY PARTIES

IMPLEMENTATION OF ARTICLE 11 (FINANCIAL MECHANISM), PARAS. 1-4

CONSIDERATION OF THE MAINTENANCE OF INTERIM ARRANGEMENTS REFERRED TO IN ARTICLE 21, PARA. 3

Issues to be addressed by the Committee

Addendum

APPROACHES TO THE DETERMINATION OF AGREED FULL INCREMENTAL COSTS

Note by the interim secretariat

I. SCOPE OF THE NOTE

1. At its eighth session, the Committee resolved to give priority at its ninth session to consideration of the implementation of Article 11 (Financial Mechanism) and to the adoption of such recommendations for decisions by the Conference of the Parties (COP) as might be necessary, in the context of the mandate of the COP, on guidance to the operating entity of the financial mechanism concerning its policies, programme priorities and eligibility criteria related to the Convention, and on the determination of "agreed full incremental costs" (A/AC.237/41, para. 91).

2. Considering the need for additional analysis of the issue of agreed full incremental costs, the Committee requested the interim secretariat to prepare another document for consideration at its ninth session, taking into account, inter alia, comments made by delegations at the eighth session (A/AC.237/41, para. 89).

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3. The present note has been prepared in response to that request. It draws on the contents of document A/AC.237/37/Add.2 submitted to the eighth session, on comments made by delegations at that session, on work carried out in the context of symposia convened by the secretariats of the Global Environment Facility (GEF) and of the United Nations Development Programme (UNDP), as well as on contributions by the non-governmental sector. It identifies a number of issues with respect to the determination of agreed full incremental costs on the basis of the information obtained from these sources.

II. BACKGROUND

4. "Agreed full incremental costs" are referred to in Article 4 (Commitments) of the Convention. Article 4.3 provides that the developed country Parties and other developed Parties included in Annex II shall provide new and additional financial resources, including for the transfer of technology, needed by the developing country Parties to meet the agreed full incremental costs of implementing measures that are covered by Article 4.1 and that are agreed between a developing country Party and the international entity or entities entrusted with the operation of the financial mechanism. (This commitment follows another for the funding of the agreed full costs incurred by developing country Parties in complying with their obligations under Article 12.1.)

5. The approach to calculating agreed full incremental costs will be important in determining the amount of funding to be received by the developing country Parties through the financial mechanism in support of their implementation of activities listed in Article 4.1. These will represent an important part of the implementation of the Convention as a whole. Other applications of incremental costs could include the ranking of projects on the basis of their cost-effectiveness in achieving the objective of the Convention.

III. CONSIDERATIONS AND ISSUES

6. The concepts of additionality and incrementality are linked in the same paragraph of the Convention and may be seen to constitute two complementary concepts. As neither concept is rigorously defined and their practical application meets with difficulties, pragmatism will have to prevail in applying both concepts in practice As far as incremental costs are concerned, approaches have been developed in various institutions to design an operational methodology. A number of issues found in such approaches are outlined below.

A. System boundary

7. Costs to be taken into consideration for assessing incrementality should, as appropriate, include capital costs, operating costs and initial costs as well as those occurring later. The costed measures may be precisely delineated, but their implementation may involve costs affecting -- beyond the project or enterprise -- the whole economy or a sector thereof. An appropriate "system boundary" should be chosen that includes all important elements economically affected by the measures. Whether and how, indirect, induced or opportunity costs should be taken into account is an issue in this regard.

B. Baselines

8. Incremental costs will be defined vis-à-vis a baseline situation, which could be not to implement a measure at all, or to implement it in a manner that does not aim at achieving the objective of the Convention. The incremental cost will be the difference between the cost of the baseline activity (which may be zero) and that of the actually implemented measure.

9. Baselines, which are essential for defining incremental costs, are necessarily hypothetical; defining them constitutes a major issue in the determination of incremental costs and is inevitably a matter for negotiation among the parties concerned. There will be a need to apply rules of economic, environmental, technical and financial reasonableness in defining baselines.

10. In the field of climate change, incremental costs are very sensitive to both the proposed measures and the baseline. In cases where the latter is specific to the country situation, this may complicate any attempt to codify standard incremental costs on the basis of an indicative list of measures. However, the determination of incremental costs would be facilitated by the development of model projects, corresponding to the substitution of typical baseline activities by typical alternatives.

C. Costs and benefits: gross or net costs

11. The consideration of various economic implications of implemented measures, including indirect implications, leads to considering both costs and benefits generated by the measures. Benefits should include the economic benefits initially intended by the baseline measures, as well as global benefits relevant to the aim of the Convention. They may also include additional local benefits, which may be in the form of avoided costs (for example, fuel savings realized by substituting a hydroelectric plant for a thermal one) or in the form of indirect, incidental benefits (such as, in the above example, tourism development linked to the availability of a lake).

12. This raises the issue of the treatment of such local incremental benefits in the determination of the agreed full incremental costs of these measures. An economic approach would suggest the subtraction of such local benefits from the costs so that only net incremental costs would qualify for financing. Whether to fund gross or net costs under the Convention is an important policy issue .

13. The implementation of the net cost approach would have the effect of concentrating funds channelled through the financial mechanism on the achievement of the objective of the Convention and of avoiding the use of resources from the financial mechanism for the generation of incremental local benefits for the developing country hosting the project. This could be viewed as consistent with a strict distinction between development funding and global funding. Such an approach could also be seen as consistent with the aim of maximizing the extent to which the objective of the Convention is approached, for a given amount of funding available through the financial mechanism.

14. Another effect of the net cost approach would be that measures that are locally economic, in that their local benefits exceed cost, would not be eligible for financing through the financial mechanism. Other activities with substantial local benefits would see their grants curtailed. Typically, such environmentally preferable projects would have higher initial costs than the baseline ones, so that the financing available to the host country for the implementation of the baseline measure would not be sufficient for the implementation of the alternative project.

15. The fact that the alternative project is economic or has important local benefits does not guarantee that the additional funds required will be available domestically or from external -- public or private -- sources. The financing of such projects deserves attention, as the projects concerned are among the most desirable ones, both economically and environmentally, and may constitute a substantial proportion of the mitigation measures useful for the implementation of the Convention. Such projects could be supported by the provision of loans -- with appropriate degrees of concessionality -- rather than grants, or by the provision of assistance in securing funding from other sources. Recourse to joint implementation would be an option in this regard, once criteria are agreed by the COP. Another approach would be to apply the rule of subtracting incremental local benefits with flexibility, particularly with respect to indirect and uncertain benefits.

16. In fact, the current practice is neither full compensation of incremental costs, nor full subtraction of local benefits. In the case of the Montreal Protocol, for example, the Multilateral Fund is only required to take savings and benefits "into account". In the operational interpretation of this provision developed by the World Bank, this is taken to mean that direct financial savings would be subtracted from the overall cost of the measure being implemented, while other types of domestic benefits -- such as environmental and intangible benefits, side benefits not financially justifiable on their own by the country concerned and benefits that are contingent or uncertain -- would not be subtracted in full, or not subtracted at all. A similar interpretation is being adopted in the operations of the Global Environment Facility (GEF).

17. Moreover, projects that appear to be economic, and therefore ineligible, could be viewed as eligible if a number of related costs that are less easy to quantify -- such as costs of risks, transactions, information gathering or market development -- were included in the "system boundary".

18. Some of the most cost-effective interventions are likely to be not projects but shifts of entire sectoral development plans, aimed at reducing emissions of greenhouse gases. In such cases one would need to compare the cost of a proposed plan with that of a baseline plan rather than operate on a project-by-project basis.

D. Discount rate

19. The consideration of costs -- occurring at different times, whether capital costs or operating costs -- leads to the need to determine and apply a discount rate. Some analysts, emphasizing intergenerational equity, recommend the use of a low discount rate to account for the long time horizon of the climate change phenomenon. Others feel that funds spent on climate change mitigation measures should be able to yield the same returns as development projects and, therefore, that these measures should be screened by the same discount rates.

20. As the determination of agreed full incremental costs does not include the valuation of global environment benefits, the use of the same discount rates as for other development projects seems warranted. Choosing a disbursement method -- either compensating costs as and when they are incurred, or making a lump sum payment compensating discounted costs -- is another issue to be addressed in deciding a financing strategy.

IV. CONCLUSION

21. The above issues, as well as others encountered in approaches to the determination of incremental costs, suggest that policy guidance on certain general aspects of such approaches would be needed. This could take the form of methodological guidelines, within which each grant would be decided through discussions between the eligible country and the operating entity concerned. In designing such a set of guidelines, care would have to be taken to achieve an effective utilization of available resources, while providing an incentive for eligible countries to implement the Convention.

22. The Committee may wish to consider whether to recommend that the COP should provide guidance on common methodological guidelines for determining agreed full incremental costs. In such a case, the COP could seek advice for this purpose from its Subsidiary Body for Scientific and Technological Advice. In providing support as required in this regard, the secretariat would draw on current activities in various institutions and in particular on work being carried out in the PRINCE programme under the auspices of the Office of the Administrator of the GEF.

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